Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Ahead of key Brexit votes in the House of Commons this evening, Gilts made gains as UK PM Johnson threatened to withdraw his Brexit bill and push for a general election if MPs didn't back his timetable to ensure ratification of the legislation by 31 October.
- Bunds followed Gilts higher while the ECB's latest Bank Lending Survey suggested little negative side-effects on financial conditions from monetary policy.
- Wednesday will see markets respond to this evening's votes in the House of Commons and the latest euro area consumer confidence data.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.670	+0.007
OBL 0 10/24	-0.616	-0.006
DBR 0 08/29	-0.374	-0.028
UKT 3¾ 09/21	0.515	-0.037
UKT 1 04/24	0.491	-0.045
UKT 0⅞ 10/29	0.704	-0.046

*Change from close as at 4:30pm BST.
Source: Bloomberg

Euro area

Bank lending survey suggests stable financial conditions

In recent months, bank lending to businesses in the euro area has accelerated, with growth reaching a decade high of 4.3%Y/Y in August. And having previously reported a tightening of conditions in Q2, today's ECB Bank Lending Survey (BLS) reported that credit standards on loans to business eased slightly in Q319. According to the survey, this was driven principally by competitive pressures, which more than offset the impact of increased perceptions of risks related to worsening economic and firm-specific conditions. Banks' costs of funds and balance sheet considerations had no material impact. Meanwhile, credit standards on loans to households for house purchase also eased slightly in Q3. But standards on consumer credit and other lending to households tightened again. Among the large member states, the easing of credit standards on business and housing loans was concentrated on Italy and the Netherlands.

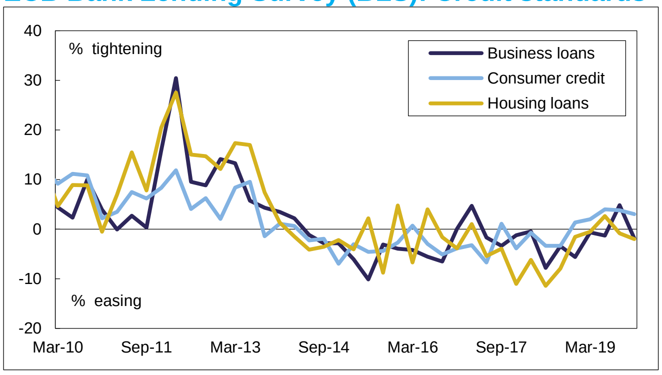
Little change in lending conditions expected in Q4

The BLS was conducted in the dozen working days following the loosening of ECB monetary policy announced at the September Governing Council meeting. Nevertheless, banks expect credit standards on all types of loans to remain broadly unchanged in Q4. In addition, having reported that net demand for business loans remained broadly stable in Q3, a similar situation is expected in Q4. And just as there was a net increase in demand for consumer credit and a more pronounced increase in demand for housing loans in Q3, the same is expected to be true in Q4, thanks not least to record low interest rates, the favourable housing market outlook and broadly positive consumer confidence.

Little evidence of net negative side effects of ECB policy

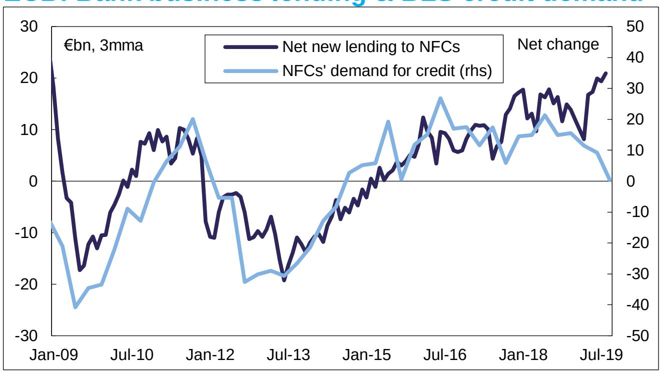
Overall, therefore, today's survey added to evidence that the ECB's highly accommodative monetary policy is not contributing to an unintentional tightening of financial conditions. Indeed, banks continued to report a positive impact of the ECB's asset purchase programme (APP) on their liquidity position and market financing conditions over the past six months, even if they also noted a negative impact from it on their profitability. The impact of the APP was judged to be most significant for housing loans, contributing to both easier credit terms and conditions and increased lending volumes, with those effects expected to continue to be felt over the coming six months. Banks also judged that the ECB's negative deposit rate continued to contribute to an increase in lending volumes and a decrease in lending rates across all loan categories despite the adverse impact on their net interest income. Overall, therefore, the survey offered little to justify the seemingly acrimonious debate on the ECB Governing Council about the appropriateness of last month's policy package.

ECB Bank Lending Survey (BLS): Credit standards



Source: ECB, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

ECB: Bank business lending & BLS credit demand



Source: ECB, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area and US

In the euro area, tomorrow will bring a couple of sentiment surveys for October, with the Commission's flash consumer confidence indicator the likely highlight. In September, the headline index rose 0.6pt to -6.5, the joint-highest level this year, nevertheless still well below the average seen through 2018. And having effectively oscillated around a sideways trend since February, we expect to see a slight drop in the indicator at the start of Q4. Wednesday will also bring the French INSEE business sentiment survey, which is expected to show that conditions remained little changed at the start of the fourth quarter, with the headline index unchanged at an above long-run average level of 106. In the markets, Germany will sell 10Y Bunds.

In the US, tomorrow will bring more housing market data with the FHFA house price index for August due alongside the usual weekly MBA mortgage application figures. In the markets, the US Treasury will sell 2Y floating rate notes and 5Y fixed rate notes.

UK

Awaiting key votes in the House of Commons

On Monday night the Government finally presented the 110-page Withdrawal Agreement Bill (or WAB), the highly detailed draft UK legislation that would implement the EU-UK Withdrawal Agreement reached last week. Among other things the text of the WAB exposed to public scrutiny many of that Agreement's most politically sensitive issues. But its publication allowed for key votes to be held in the House of Commons this evening that might determine whether the UK could leave the EU on 31 October or whether an extension would need to be granted by the EU. For a start, MPs were set to hold a 'second reading' vote to test whether support exists in principle for the draft legislation. While defeat for PM Johnson would kill the bill, at the time of writing he appeared to have the numbers in Parliament required to win that vote. And such success would allow the WAB to move later tonight to the committee stage, where MPs would scrutinize the legislation and propose detailed amendments. So far, the tabled amendments include a proposal for the Government to negotiate a customs union during the transition period and a two-year extension to the end of the transition period to December 2022. Other amendments in due course might include whether the approval of the legislation should depend upon its confirmation in a second referendum.

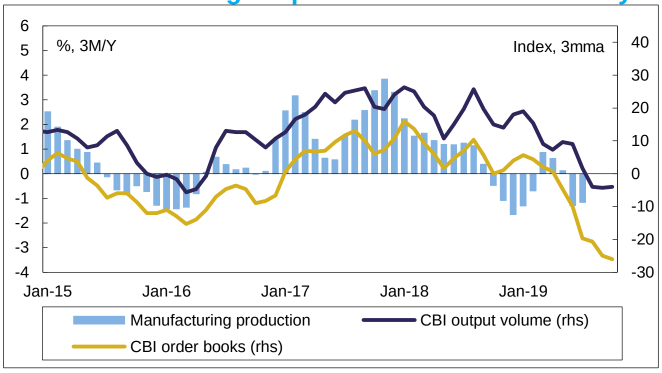
WAB timetable absurdly compressed

Most uncertain today, however, was whether the Government would win a separate vote on a 'programme motion', which sought an extraordinarily accelerated timetable to allow the WAB to pass into law by the end of the month. In particular, according to the proposed timetable, MPs would have only until the end of Thursday to scrutinize, amend and endorse the entire WAB before sending it off to the House of Lords for its own round of scrutiny, amendment and voting. In contrast, MPs had required more than five weeks to conduct the same tasks for the previous Treaties of Rome and Maastricht in 1972 and 1993 respectively. Given the wholly unreasonable nature of the proposed timetable for such a lengthy and profoundly important piece of legislation as the WAB – which is the most constitutionally important piece of UK legislation since those Treaties if not before – we had strong doubts that the Government would win this vote.

Johnson to seek election if programme motion is defeated?

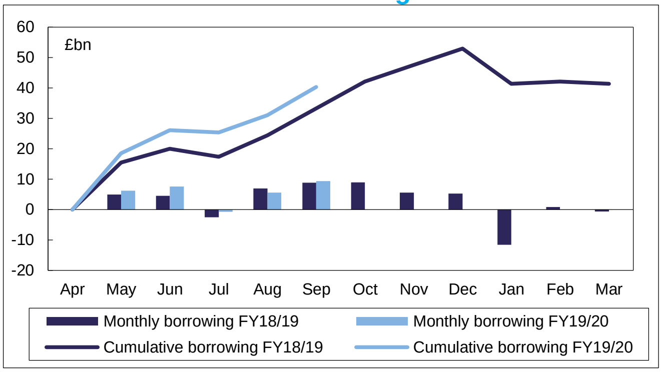
If, as we expect, the WAB passed its second reading this evening, the UK would be on track to leave the EU whatever happened in the programme motion. But if the Government lost that second vote, at a minimum further time beyond 31 October would be required for the WAB's ratification. However, in the Parliamentary debate this afternoon, Johnson repeated the threat that, if the programme motion was defeated, he might withdraw the WAB and seek an early general election instead. That threat conspired to push Gilts higher and sterling slightly lower. Nevertheless, regardless of what happens in this evening's votes, and which path ahead Johnson chooses, we have no doubt that the EU would be willing to grant the necessary Article 50 extension and avoid a no-deal Brexit next week.

UK: Manufacturing output & CBI industrial survey



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing



Source: ONS and Daiwa Capital Markets Europe Ltd.

Optimism about export orders at near-two-decade low

The negative impact of ongoing Brexit uncertainty on the UK economy was again evident in today's CBI industrial trends survey, which suggested that manufacturers were particularly gloomy about the near-term outlook against the backdrop of weaker production and orders at the start of Q4. In particular, the survey's output component signalled a notable weakening in production over the past three months, with the relevant index down 11pts in October to -10, the second lowest since March 2016, driven by a notable drop in the autos sector. And firms anticipated a steeper pace of decline over the coming three months too. Certainly, the survey indicated a further marked decline in new orders this month, with the index (-37) the lowest for more than 9½ years. Export orders slumped to the weakest on the survey for a decade, while there was also limited evidence of Brexit-related stock building ahead of the end-October deadline. The accompanying quarterly survey suggested that the share of manufacturers citing political and external economic conditions as a limiting factor for export orders was the highest on record. As such, firms' optimism about export prospects over the coming year plummeted to the lowest level for eighteen years. And with overall business optimism having also declined sharply, manufacturers' employment plans over the coming three months and investment intentions for the year ahead fell to the lowest since the Global Financial Crisis.

Public borrowing incompatible with Government's fiscal rule

Close to expectations, public sector net borrowing rose to £9.4bn in September, up from £8.8bn a year earlier. The rise in the deficit reflected increases of 4.6%Y/Y in current public expenditure and a whopping 31.2%Y/Y in public investment, which was only partially offset by surprisingly strong growth of 6.9%Y/Y in government receipts (5.0%Y/Y excluding a special dividend from the government's holding in RBS). So, the deficit maintained the trajectory above last year's level that has been in play since April, and took cumulative borrowing in the fiscal year to date to £40.3bn, £7.2bn more than over the same period in FY18/19. On current trends, borrowing in FY19/20 will be more than £50.5bn, and on a path incompatible with the Government's current fiscal rule to reduce cyclically adjusted borrowing below 2% of GDP by 2020-21. Indeed, what earlier this year had appeared to be headroom of more than 1% of GDP against that fiscal target has already evaporated due to those poor fiscal outturns since March, changes to the accounting treatment of student loans, and the budgetary incontinence of new Chancellor Sajid Javid, who – blatantly electioneering with taxpayers' money – pledged lashings of extra public spending in his Spending Round for 2020-21 to try to persuade voters that austerity is a thing of the past. Of course, knowing full well that he's now off track, Javid has also pledged to rewrite the Government's fiscal rules when he unveils the 2019 Budget, which is currently penciled in for 6 November.

The day ahead in the UK

With no UK data of note due tomorrow, focus will remain firmly on Brexit. But the order of business in Parliament will crucially depend on the Government's response to this evening's votes on the WAB's 'second reading' and 'programme motion'.

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Spain		Trade balance €bn	Aug	**-4.0**	-	-2.5	-
UK		Public sector net borrowing (excluding public sector banks)	Sep	**8.7 (9.4)**	8.9 (9.7)	5.8 (6.4)	4.9 (5.6)
		CBI industrial trends survey, total orders	Oct	**-37**	-30	-28	-

Auctions

Country		Auction
UK		sold £3bn of 0.625% 2025 bonds at an average yield of 0.535%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		15.00	Consumer confidence indicator	Oct	-6.8	-6.5
France		07.45	Business confidence indicator	Oct	106	106
		07.45	Manufacturing confidence indicator (production outlook)	Oct	102 (5)	102 (4)

Events & Auctions

Country		BST	Auction/Event
Germany		10.30	Auction: to sell €3bn of 0% 2029 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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